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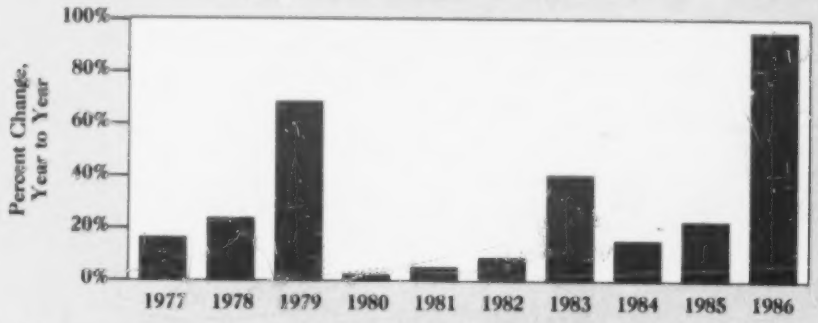
American Council for Capital Formation
Center for Policy Research

SPECIAL REPORT

September 1989

The Importance of Capital Gains Tax Rates to Individual and Corporate Investors

Chart 1: Individual Capital Gains Realizations, 1977–1986



Note: Percent change calculated from realized net long-term capital gains less net long-term capital losses.

Chart 2: S&P 500 Stock Average, 1977–1986

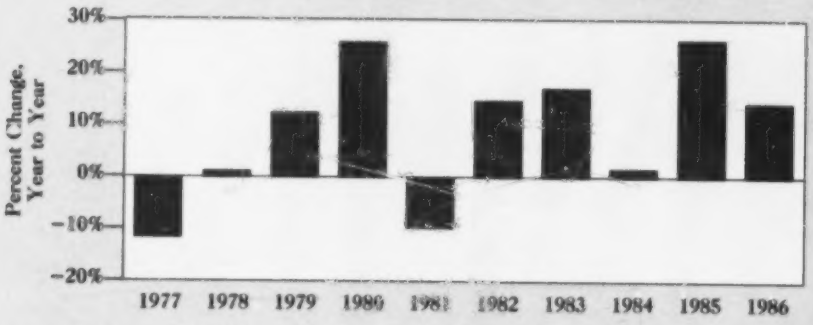
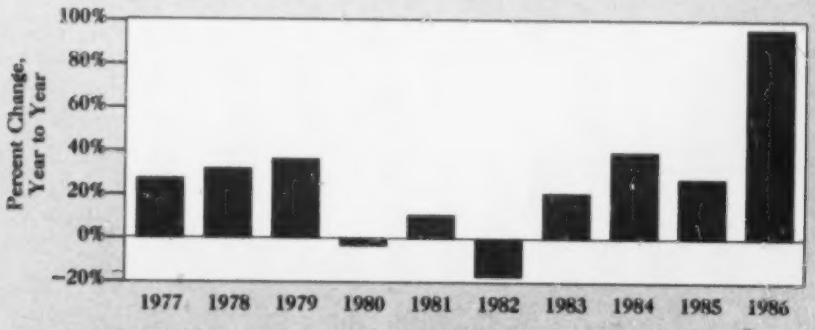


Chart 3: Corporate Capital Gains Realizations, 1977–1986



Note: Percent change calculated from net capital gains taxed at alternative rates. Data are based on corporations with net income minus holding and other investment companies, except bank holding companies.

Sources: Chart 1: Internal Revenue Service, Statistics of Income, *Individual Income Tax Returns*, various issues, Washington, D.C.; Chart 2: Standard and Poor's Composite Index of 500 Stocks; Chart 3: Internal Revenue Service, Statistics of Income, *Corporation Income Tax Returns*, various issues, Washington, D.C. Charts prepared by the American Council for Capital Formation Center for Policy Research, September 1989.

Tax Law Changes Influence Capital Gains More than S&P 500

Individual capital gains realizations appear to be affected more by tax rate changes than by the performance of the stock market (charts 1 and 2). In 1979, individual capital gains realizations rose by almost 70 percent in response to a cut in capital gains taxes from a maximum of 35 percent to 28 percent, which took effect in November 1978. The Standard and Poor average of 500 stocks, in contrast, rose only 12 percent in 1979. Similarly, in 1981, the year in which individual capital gains tax rates declined to a maximum of 20 percent, realizations rose by 5 percent in spite of a 10 percent drop in the S&P average. The prospect of paying capital gains taxes of up to 33 percent in 1987 was apparently enough to cause a surge of sales in 1986 after the passage of the Tax Reform Act of 1986. Individual realizations increased by almost 96 percent as taxpayers rushed to sell assets before the new, higher tax rates took effect in 1987. S&P stock prices, by comparison, rose only 15 percent in 1986.

Corporate capital gains realizations also seem to respond more to tax rate changes than to variations in stock prices (chart 3). The capital gains included in chart 3 are those reported by corporations with net income, exclusive of "pass-through" investment companies whose gains are taxed at individual capital gains rates. The 1979 tax cut was only 2 percentage points, from 30 to 28 percent, but realizations jumped by 37 percent compared to a 12 percent increase in

the S&P 500. Corporate capital gains in 1986 show a strong response to the passage of the 1986 tax act similar to that of individuals. Realizations rose by 95 percent compared to a 15 percent increase in the S&P 500. The data suggest that corporate taxpayers were selling in order to avoid the 34 percent maximum capital gains rate that took effect in 1987.

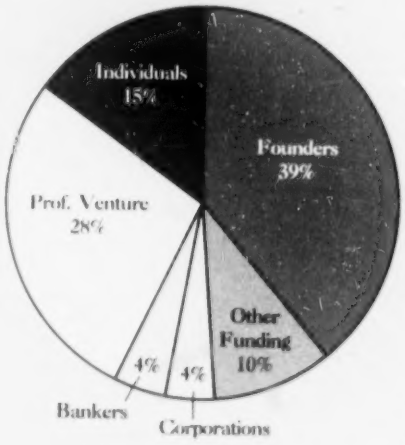
Thus, it seems likely that reductions in current corporate and individual capital gains tax rates could stimulate similar increases in capital gains realizations, thereby creating additional tax revenues.

Taxable Investors Play Large Role in Start-Up Financing

Taxable investors provide the majority of the risk capital for new firms in the start-up period, according to a new survey of young technology companies and their risk capital requirements by the National Venture Capital Association, the American Electronics Association, and Coopers & Lybrand. The survey also shows that these investors are more interested in capital gains than dividends.[1]

Sources of Funding. Coopers & Lybrand (C&L) compiled information provided by 523 firms belonging to the American Electronics Association or the National Venture Capital Association. C&L concluded that the new firms' founders provided 39 percent of the capital during the start-up period; individual investors, 15 percent; and other taxable investors, an additional 18 percent (see chart). Only 28 percent of the capital came from professional venture capitalists.

Individual Investors Critical During Founding Period
(share of total funds)



According to Coopers & Lybrand, capital provided by founders and other individual investors, as well as capital provided by corporations and other investors, is critical to the formation of young growth companies.

These results are consistent with the results of other studies indicating that institutional venture capital firms provide only about 5 percent of the total capital ($60-$80 billion) consumed by young growth companies in the U.S. every year. Since only half of this 5 percent comes from tax-exempt sources, the conclusion is clear. The vast majority of investors who provide the risk capital to invest in America's new technology companies are subject to capital gains taxation, according to C&L.

Importance of Capital Gains to Investors. Investors in start-up companies are seeking capital gains rather than dividends, according to the survey. Dividends paid by companies formed between 1966 and 1985 average in the range of 0–0.4 percent of equity. For companies formed in the second half of this time period, the dividend yield is virtually zero. Even for the oldest group (respondent companies formed between 1966 and 1970), the dividend yield is a minuscule 0.4 percent.

The reasons are straightforward. Growth companies consume significant amounts of capital to finance the asset growth required for revenue and profit growth. While such companies could theoretically pay large dividends, doing so would mean raising more money from capital markets.

As a result, growth companies overwhelmingly retain their earnings within the company to help build their equity and asset base. Then, as the company grows, these retained earnings add to the equity per share and to the value that the shareholder eventually can realize by selling stock for a capital gain.

Implications. The implications of the survey for economic and tax policy are straightforward:

1 The United States must encourage the formation of young companies, which play a critical role in the growth of productivity and jobs in our economy.

2 Policies that stimulate the formation and growth of such companies will pay off rapidly in our economy.

3 Tax policy that reduces the taxation of dividends and short-term capital gains while increasing the taxation of long-term capital gains (such as the Tax Reform Act of 1986) works to the disadvantage of young growth companies.

Concluding that such tax policy has damaged the environment for "the goose that lays golden eggs," the study calls for prompt changes in U.S. economic and tax policy.

[1] "Generating Economic Growth through Young Technology Companies," a survey of young technology companies and their risk capital requirements by the National Venture Capital Association, the American Electronics Association, and Coopers & Lybrand, September 1989.

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to promote an understanding by the public of the importance of capital formation to the economy. For additional information please contact: ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington D.C., 20006, (202) 293-5811.